BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
FAIRCHILD INDUSTRIES, INC.)

For Appellant: Lawrence M. Brauer
Director, Taxes and Tax Counsel

For Respondent.: John R. Akin
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Fairchild Industries, Inc., against proposed assessments of additional franchise tax in the amounts of $16,075.08, $30,284.79, $27,453.28 and $27,503.05 for the income years 1969, 1970, 1971, and 1972, respectively.

The issue presented is whether qains realized by appellant from the sale of an exclusive license of certain patents constituted business income apportionable to California by formula, or nonbusiness income specifically allocable to appellant's Maryland situs.

Appellant, a large corporation enqaqed in unitary business operations, has its commercial domicile in Germantown, Maryland. In early 1953, it entered into a letter aqreement with George Sullivan in which Sullivan qranted licenses to appellant with respect to various patent applications pertainina to liqhtweiaht weapons. Appellant aqreed to finance production of six firearms incornoratinq Sullivan's inventions. Sullivan was not employed by appellant at that time.

In October 1954, appellant and Sullivan executed a formal license aqreoment superseding the 1953 letter aoreement, and Sullivan was retained bv appellant under a manaqemcnt and consultinq contract. At the same time, appellant formed the Armalite Division ("Armalite") to pursue its work in the area of liqhtweight weapons.

In staffinq Armalite, appellant hired Euqene Stoner. Stoner had previously been workina independently to develop a gas svstem for liqht arms. At the time of his employment, Stoner had conceived of an idea for a piston-less qas svstem, but had not as yet reduced the idea to practice. Sometime after he was employed, Stoner assiqned his riqhts in the qas system invention to appellant. As a condition of employment, he also aqreed to assiqn to appellant any other inventions he conceived while employed at Armalite.

From 1954 to 1958, work continued 'at Armalite on the development of various liqhtweiqht weapons. Durinq this period, the AR-l, AR-2, AR-5, AR-9, AR-11, AR-15, and AR-16 rifles were developed. The Stoner qas system was perfected and incorporated into the AR-10 (another firearm developed and manufactured by Armalite), the AR- 15, and other rifles. A patent application for the Stoner system was filed on Auqust 4, 1956, and the patent was suhseauently issued on September 6, 1960. In addition, several other inventions developed by Stoner were patented.

In 1957, appellant, throuqh a wholly owned subsidiary, Fairchild Arms International, Ltd., qranted a nonexclusive license to a Dutch corporation to manufacture and sell liqhtwciaht firearms usinq several of

appellant's patents. Two years later, appellant executed a nonexclusive license and technical aqreement with Colt's Patent Firearms Manufacturinq Company, Inc. (subseauentlv known as Colt Industries, Inc., and hereinafter referred to as "Colt"). Under this aqreement, Colt was authorized to manufacture and sell the AR-10 and AR-15 worldwide, and appellant was required to furnish technical assistance to Colt in order to enable it to begin manufacturing these weapons. Subsequently, the M-16 rifle, which incorporated various aspects of both the AR-10 and AR-15, was successfully marketed by Colt to the United States Government.

After the execution of the Colt aqreement, Armalite continued to operate in a limited manner and attempted to market liqhtweiqht sporting rifles. Armalite's onerations did not meet with particular success, but it did manufacture and sell limited quantities of weapons incorporating patented features used in the AR-10 and AR-15 rifles.

In February 1961, appellant sold the Armalite assets and name to Sullivan. The Dutch license, the Colt license, and the patents relatinq to the AR-10 and AR-15 weapons were, however, specifically excluded from that sale. On October 12, 1961, the license with the Dutch corporation was terminated.

On December 12, 1961, appellant executed an aqreement with Colt wherein it sold Colt an exclusive license to the patent riqhts relatinq to the M-16 rifle up to the expiration date of the last-to-expire patent. The aqreement included the riqht to qrant sub-licenses, but did not cover the riqht to reassiqn the patents or the aqreement. The purchase price was based, primarily, on subsequent sales by Colt of M-16 weapons and parts incor'poratinq the above mentioned patent riqhts. Since 1963, appellant has received payments from Colt and made payments to Sullivan and Stoner, the developers of the relevant patent riqhts, based on their license agreements with appellant. The issue to be determined is whether the income realized by appellant from the sale to Colt of the exclusive license to these'patent riqhts was business income apportionahle to California by formula, or nonbusiness income specifically allocable to appellant's commercial domicile.

The fact that anpellant realized qains as a result of its sale of the exclusive license to Colt is not disputed, nor do the oar-ties disasree as to the

actual amount of such qains. In addition, appellant agrees with the position of the Franchise Tax Board (hereinafter "respondent") that, until the execution of the exclusive license agreement with Colt on December 12, 1961, the income derived from its earlier licensing agreements was business income. It argues, however, that the sale of Armalite in February 1961 was an "identifiable event" siqnifyinq its "permanent withdrawal" from the liqhtweiqht weapons business. Consequently, appellant argues, the relevant patent riqhts, which it had previously used in its arms business, could not be used again because it had divested itself of Armalite and therefore lacked the capability of resuming its light arms business. Appellant contends that the status of its interest in the pertinent patent rights changed upon the sale of Armalite from that of a valuable business asset to "investment" prooerty, the income from which is nonhusiness income. Respondent determined, however, that appellant's gain from the December 12, 1961, sale of its patent riqhts constituted business income and, therefore, was apportionable to California by formula.

The Uniform Division of Income for Tax Purposes Act (UDITPA) was adopted by California, effective for years beainninq- after December 31, 1966. (Rev. & Tax.Code, §§ 25120-25139.) Section 25120 of the Revenue and Taxation Code defines "business income" and "nonbusiness income" as follows:

> (a) "Business income" means income arising from transactions and activity in 'the regular course of the taxpayer's trade or business and includes income from tangible and intanqible property if the acquisition, management', and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.
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> (d) "Nonbusiness income" means all income other than business income.

For the years in question, resoondent's regulations interpretinq Revenue and Taxation Code section 25120 provided:

> As a general rule, qain or loss from the sale, exchanqc or other disposition of real

> or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used to produce business income. However, the gain or loss will constitute nonbusiness income if such property was subsequently utilized principally for the production of nonbusiness income or otherwise was removed from the property factor. ... (Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(2) (Art. 2).)

The origin of the definition of "business income" contained in section 25120 of the Revenue and Taxation Code can be traced to the decisions of this Board in Appeal of Houghton Mifflin Co., decided March 28, 1946; Appeal of International Business Machines Corp., decided October 7, 1954; and Appeal of National Cylinder Gas Co., decided February 5, 1957. (See J. H. Peters, The Distinction Between Business Income and Nonbusiness Income 25 S. Calif. Tax. Inst. 251, 276-279 (1973).) In those three cases it was held that income from intangibles is business income subject to apportionment by formula where the acquisition, management, and disposition of the intangibles constitute an integral part of the owner's regular business operations. (Accord, Appeal of American Snuff Co., Cal. St. Bd. of Equal., April 20, 1960; Appeal of The United States Shoe Corp., Cal. St. Bd. of Equal., Dec. 16, 1959; Appeal of Union Carbide and Carbon Corp., Cal. St. Bd. of Equal., Aug. 19, 1957; Appeal of Marcus-Lesoine, Inc., Cal. St. Bd. of Equal., July 7, 1942.)

Section 25120 of the Revenue and Taxation Code provides two alternative tests to determine whether gain or loss on the disposition of property constitutes business income. The first is the "transaction" test. Under this test, the relevant inquiry is whether the transaction or activity which gave rise to the gain or loss occurred in the regular course of the taxpayer's trade or business. Under the second, or "functional", test, all income from property is considered business income if the acquisition, management and disposition of the property were "integral parts" of the taxpayer's regular business operations, regardless of whether the income was derived from an occasional or extraordinary transaction. (Appeal of Borden, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977; Appeal of General Dynamics Corporation, Cal. St. Bd. of Equal., June 3, 1975, opinion on denial of rehearing, Sept. 17, 1975; Cal. Admin. Code, tit. 18, reg. 25120, subd. (c) (Art. 2).) If

either of the two alternative tests provided in section 25120 is met, the gain or loss resulting from the disposition of property will constitute business income. We are satisfied that the income produced from appellant's sale of the exclusive license to Colt resulted in business income under the "functional" test. Accordingly, we are not called upon to decide if the "transaction" test has also been satisfied.

The patents involved in the sale of the exclusive license to Colt were developed for use in appellant's regular business operations, patents were acquired to protect the value of appellant's inventions, and appellant executed licensing agreements to exploit their value. It is evident from the above that the acquisition, management and disposition of those patents were integral parts of the taxpayer's regular business operations. When income is realized from assets which are integral parts of a unitary business, it is considered business income, subject to apportionment by formula, even if it arises from an extraordinary disposition of the property. (Appeal of Kroehler Manufacturing Company, Cal. St. Bd. of Equal., April 6, 1977: Appeal of Velsicol Chemical Corp., Cal. St. Bd. of Equal., Oct. 5, 1965; Appeal of Borden, Inc., supra (all involving income arising from intangibles); see also Appeal of American Airlines, Inc., Cal. St. Bd. of Equal., Dec. 18, 1952 and Appeal of American President Lines, Ltd., Cal. St. Bd. of Equal., Jan. 5, 1961, wherein we held that income derived from the sale of tangible assets used in the taxpayers' businesses was unitary business income.) Consequently, we must conclude that the income realized by appellant from the sale of the exclusive license to Colt constituted business income. As we explained in Appeal of W. J. Voit Rubber Corp., decided May 12, 1964:

> . . . any income from assets which are integral parts of the unitary business is [business] income. It is appropriate that all returns from property which is developed or acquired and maintained through the resources of and in furtherance of the business should be attributed to the business as a whole.

Appellant has argued that upon the sale of Armalite, the status of the patents in question changed from business property to investment property and, therefore, the income derived from the sale thereof was

nonbusiness income. In support of its position, appellant cites respondent's regulations for the proposition that property used in a business remains in the property factor for purposes of apportionment of business income until its permanent withdrawal is established by an identifiable event such as its sale or conversion to the production of nonbusiness income. (Cal. Admin. Code, tit. 18, reg. 25129, subd. (b) (Art. 2).) This regulation is, however, irrelevant to the instant appeal. Revenue and Taxation Code section 25129 provides:

> The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the income year. (Emphasis added.)

Appellant's argument ignores the fact that patents, being intangible property, do not constitute part of the property factor. Consequently, patents are not subject to the rule set forth in respondent's above cited regulation.

It should also be noted that there is an inconsistency in appellant's argument. Appellant submits that the nature of its interest in the patents in question changed from business to investment property on February 12, 1961, the date of the sale of Armalite. Yet it acknowledges that the income derived from the nonexclusive license to Colt continued to be business income until December 12, 1961. If the patents had in fact changed from business to investment property on February 12, 1961, as submitted by appellant, then the nature of the income derived therefrom would also have been altered at that time.

In accordance with the views expressed above, we conclude that respondent's action in this matter must be sustained.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Fairchild Industries, Inc., against proposed assessments of additional franchise tax in the amounts of $16,075.08, $30,284.79, $27,453.28 and $27,503.05 for the income years 1969, 1970, 1971 and 1972, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 1st day of August , 1980, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____ Member